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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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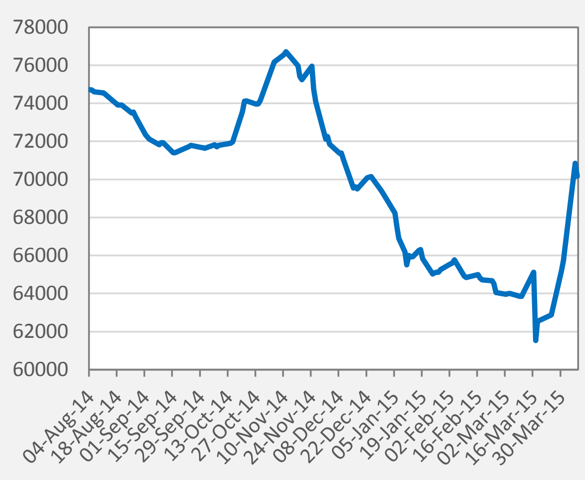
The Framework Agreement – economic implications

Relief and optimism reverberated around the Iranian business community following last week's announcement of a Framework Agreement with the Western powers. But substantial gaps remain, not least the sequencing of sanctions-removal. In the meantime, the economy will feel little respite. But if a comprehensive deal can be reached, enormous rewards await Iran's beleaguered economy.

Almost a week after the historic framework accord was struck between Iran and the P5+1 powers, a clearer picture of the economic implications of a final deal are coming into view. Despite intense negotiations that came close to failure on numerous occasions, the 2nd April announcement went further than most were expecting, providing greater detail about the potential shape of a final deal than has ever been reached before. The achievement is to be celebrated, although major gaps are yet to be bridged. Gaps include the manner of sanctions relief, which will be critical to how the final deal *will feel* for the Iranian economy and its citizens. Western reading of the framework agreement is clear about a process of phased sanctions-removal with a "snap-back" clause in case Iran breaches the terms of the deal. Iranian authorities have marketed a very different interpretation at home, detailing a full removal of all US, European and UN sanctions upon implementation of the agreement. Such details could yet prove a major stumbling block to a final deal.

The immediate reaction to the 2nd April announcement was predictably jubilant in the streets and financial markets of Tehran. The TEDPIX stock index gained 8% in a week, including a record one-day rise of 2400 points, although this is from a low-base. Fig 1 puts this rise in perspective, with the market still only reaching mid-December levels and nowhere near the late 2013 peak. The foreign exchange market tells a similar story. The rial gained a modest 3% on the dollar since mid-March in the open market. This closed the gap on the official rate but is not a dramatic shift. Markets are clearly pricing in the major uncertainties that remain.

Fig 1. TEDPIX Stock index
(October 2014 to present)



The period between now and any final deal will still be tough for the Iranian economy. A bump in business confidence may lead to a modest rise in spending, and the continuation of talks means the monthly foreign exchange provision continues, under the terms of the interim deal. But the fundamentals of the economy remain depressed– low oil prices, slow growth, high unemployment, fiscal contraction, excess capacity, financial constraints.

If a comprehensive deal can be signed by 30th June, VerityIran expects an immediate, positive impact on the Iranian economy, which would accelerate and expand as the year progressed. We expect an immediate surge of pent-up demand to flow through Tehran's capital and equity markets, and to significantly strengthen the rial, providing a boost to Iranian purchasing power. Private investment and trade flows would quickly follow as businesses give the "green light" to the large and varied catalogue of deals that have been put on hold by sanctions. The petrochemical industry has been developing new investment projects for months, as have major firms in the mining, steel, aviation and automotive sectors. Whether direct targets of sanctions or not, all Iranian exporters have felt the burden of Iran's isolation from the international financial system in recent years and the survivors will be quick to return.

Within the year, the Iranian authorities claim they can add 1 million barrels of oil per day to production, returning to 2011 levels (Fig 3). Recent reports have suggested up to 30 million barrels of Iranian oil is currently stored at sea and ready for immediate sale should sanctions allow. Add to this injection of funds the renewed access to Iran's stockpiles of export revenues and reserves, currently trapped in overseas bank accounts. Reports emerged this month that Indian oil refineries alone owe US$8.8bn in unpaid bills to Iran, for example.

Despite such prospects, Iran's Finance Minister and Central Bank Chief have both gone out of their way to manage expectations about the post-sanctions environment. Iran's unbalanced economy, irrational welfare systems, creaking infrastructure, weak banking sector and high levels of corruption would remain a challenge. The oil price will also inevitably dampen expectations about Iran's resurgence, not least because increasing Iranian production

Fig 2. Rial:USD exchange rate, official rate (bottom), market rate (top) (Dec 2014 to

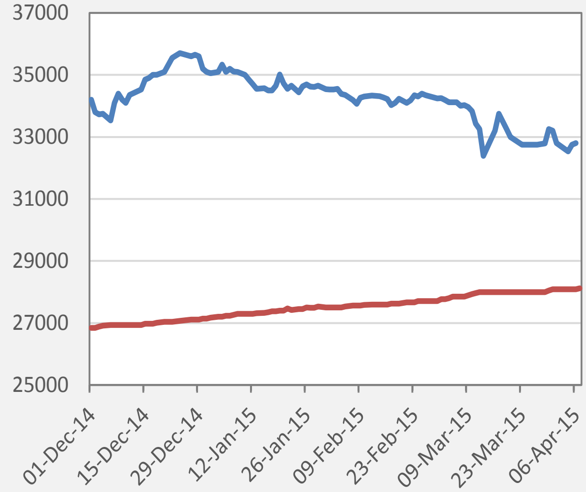


Fig 3. Iranian Crude Oil production, annual (2000-2013, thousand bpd)

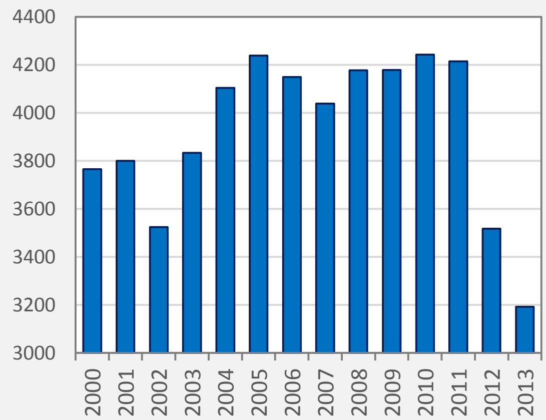
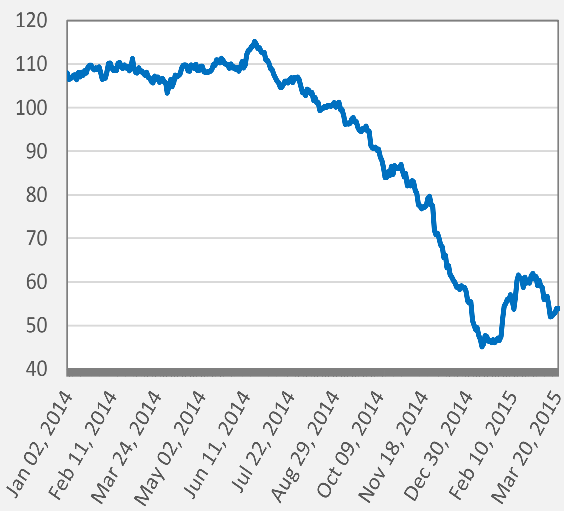


Fig 4. Brent Crude oil price (closing)
US$ per barrel



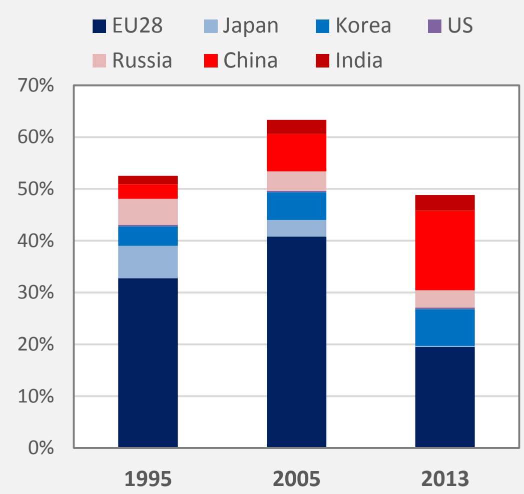
will only add further pressure to an already oversupplied global market, and because much of the investment required in Iran's oil fields would depend on high returns. Our sources suggest new wells will only break even at US$118-120 per barrel, which is unlikely in the next year (Fig 4).

The framework agreement has created a degree of momentum in Iran's business community that raises the cost of failure even higher. Should the remaining gaps not be bridged by the 30th June deadline, VerityIran expects a break-down in the negotiation process with immediate and far-reaching economic repercussions. Psychologically, the persistent sense of hope that VerityIran has observed among its Iranian business contacts over the past three years, which has held together much of the fabric of the Iranian economy, would be dashed and replaced by a much gloomier expectation of inexorable decline. This administration's achievements in stabilising inflation are much heralded, but for regular Iran-economy watchers, just as impressive is the aversion of a major banking crisis. The crash in confidence following a breakdown in talks would instigate a surge in capital flight, which would destabilise an already weak financial sector.

A closer look at the drivers behind Iran's recent recovery in GDP reveal a lot about the economy's likely lack of resilience to a collapse in talks. The latest report by the Central Bank claimed that GDP growth had reached 2.35%, year on year. The boom in non-oil exports (heavily dominated by petrochemicals and condensates), which has been "allowed" to grow under the good will of the interim deal with the P5+1 has been central to this. In a failed-talks scenario, this trade would be quick to suffer. The foreign-exchange dividend of the interim talks would also come to an end, closing down a valuable lifeline to government spending and foreign exchange liquidity. The rise in investment in the past year would likely reverse as Iranians do everything they can to smuggle their assets out of the country to protect their value. Government spending would be forced to contract.

There are important longer-term economic implications too for a failure to reach the deal. In recent years, trading relationships have already gravitated towards the East and "non-aligned" partners, to replace lost sales to the West. Iranian consumers and enterprises bemoan the loss of quality in consumer goods and industrial parts and services as affordable partners in the West have become more difficult to find. Fig 5 shows the extent of the shift between 2005 and 2013, as the share of imports from Western partners in blue almost halves at the expense of the big emerging economies and others. This trend would be accentuated if nuclear talks broke down, as the Iranian dependency on Chinese, Indian and Russian imports becomes cemented into the long term. This month, the Iranian Customs Administration announced that trade with China had risen 30% in the past year, and now accounts for one quarter of all Iran's trade.

Fig 5. Origin of Iranian imports
(% share of total imports)



Ultimately, and most importantly, the consequences of a failure of the negotiations process would be felt most bluntly in the wellbeing of millions of ordinary Iranian households. The Iranian Labor News Agency released a report last month tracking trends of Iran's "Misery index", a composite measure of unemployment and living costs. The index had gained 24 points in the past 6 years (Fig 6). That trend, we believe, would be the only one guaranteed to follow an upward trajectory over the next five years if Iran and the P5+1 powers fail to reach a comprehensive deal this summer.

Fig 6. Misery Index, Iran
(1376-1392, 1997/8 – 2013/14)